EDISON

Listed Private Equity

The opportunities and challenges for investors

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In the first part of a series of reports on listed private equity (LPE), we examine the key opportunities and issues for investors.

Private equity has delivered strong returns

The global private equity (PE) market is substantial, with over 20,000 funds managing some $2.4tn, according to Preqin. PE has produced consistently strong compound average investment returns over the last few decades in the order of 14% pa and has become a core asset class in institutional investors' portfolios. However, the long-term nature of PE funds means liquidity is limited and typical minimum investment levels of $1-10m restrict accessibility to sophisticated investors such as pension funds, endowments and other institutions, high net worth individuals and family offices.

Listed private equity: The best of both worlds?

The LPE structure addresses the limitations on accessibility and liquidity posed by the traditional limited partnership (LP) model used by PE. LPE allows investors simple, liquid access to an attractive asset class for the price of one share, albeit with reduced information and less efficient cash management than in the LP structure, as well as the additional costs involved in running a listed company.

Untapped growth potential

Given the intuitive appeal of LPE, there appears to be significantly untapped potential to grow the sector. The listed private equity (LPE) sector is small compared to the overall PE industry. The shareholder registers of LPE funds do not on average reflect the growing dominance of private client wealth managers and sophisticated retail investors (via platforms) in the investment company sector as a whole. As a result, LPE funds have recently been trading at wide discounts to net asset value (NAV) of >20% even though investment performance has been good over the last five years.

This implies there is an information gap which, if addressed through wider engagement with the investor community, could help move LPE more into the investment mainstream. Recent corporate actions by informed, sophisticated investors, such as the bid by HarbourVest for SVG Capital, might indicate that the market is beginning to recognise the mismatch between low LPE fund valuations and strong underlying investment performance. This suggests there might be an interesting value opportunity for investors in the sector now.

Companies in this report

3i Group
Aberdeen Private Equity Fund**
Altamir SCA***
Candover Investments
Deutsche Beteiligungs***
Electra Private Equity*
F&C Private Equity Trust*
GIMV NV*
HarbourVest Global Private Equity***
HBM Healthcare Investments***
HgCapital Trust*
ICG Enterprise Trust*
International Biotechnology Trust**
NB Private Equity Partners*
Oakley Capital Investments*
Pantheon International*
Princess Private Equity Holding*
Scottish Mortgage Investment Trust
Standard Life European Private Equity Trust***
SVG Capital
Woodford Patient Capital Trust

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Why private equity (PE)?

The PE return opportunity

Private equity (PE) is an ownership model whereby a PE firm, backed by third-party investors, takes a majority or significant minority equity stake in a private (unlisted) business. The PE firm is represented by the general partner (GP), who selects and manages the investments in the interests of the third-party investors or limited partners (LP). Typically, target businesses are those with high growth prospects and/or those where performance and value can be significantly improved with the aim of selling the business for a profit in the future. A key feature of PE funds is their long time horizon but ultimately limited life, usually 10 years with the option to extend for perhaps an additional three years.

The PE market is dominated by traditional limited partnership (LP) structures, as opposed to listed private equity companies. For instance, Preqin (the PE industry data and intelligence provider) covers over 20,000 PE funds and 10,000 PE firms globally and aggregates performance data for nearly 6,500 PE funds worldwide, managing assets of $2.4tn (Preqin Private Equity Spotlight, September 2016). By contrast, LPEQ (see Appendix) estimates the number of LPE funds at only 250 globally.

PE enables investors to gain access to opportunities not available in public markets. PE is well-suited to financing innovative new technologies and business models, which often require significant initial and ongoing investment.

PE is not a homogeneous asset class and offers investors a great deal of diversification opportunity. For instance investors can choose exposure by vintage year, geography, industry, and strategy and investment stage. Strategies include buyout (where a controlling stake in a business is acquired), growth capital (where a minority stake in an established business is acquired in order to drive a growth strategy), venture capital (where start-up or early-stage capital is provided) and fund-of-funds (where the GP invests in a number of other PE firms funds) This diversification may help explain why investors find not only the return attractive, but also the **return vs risk trade-off**.

The PE model is attractive to incumbent corporate management, as it can focus on growing the business for the long term without being bound by short-term performance targets or having to deal with the costs, reporting and regulatory requirements of being a listed entity. By contrast, institutional public market equity investors and equity analysts tend to be more short-term focused and place revenues and earnings above growth and market potential when valuing companies.

According to a study (*Examining private equity's place in investors' portfolios*, October 2015) by the British Private Equity & Venture Capital Association (BVCA), the principal reason given by investors for investing in PE is the strong absolute return potential, with investors expecting an internal rate of return (IRR) of between 15% and 20% pa. Indeed, PE has demonstrated its attractiveness as an asset class over long time periods. For funds at least four years old, PE in the UK has generated a 13.8% pa net IRR after all fees on investments made in the period 1980-2014. **Relative** returns have also been impressive: in the last 10 years the net PE IRR has been 14.9% pa compared to a total return of 7.6% pa for the FTSE All-Share index and 7.8% for pension fund assets (source: *BVCA Private Equity and Venture Capital Performance Measurement Survey 2014*).

The PE ownership model

The PE ownership model is highly differentiated from the public market investment and management model. The typical PE firm is structured around specialist teams focusing on sector

and market knowledge, operations and management, investment, finance and deal execution. They also draw on extensive networks of sector experts and senior executive talent.

The investment cycle can be broken into three phases:

- The pre-investment phase involves PE investment teams building relationships with target management, usually over months or years. This positions them to conduct comprehensive due diligence and effectively become 'insiders' as they build the investment thesis.
- In the ownership phase, this close monitoring remains in place via, at a minimum, board representation. The PE team also contributes extensive strategic management and operational input through the board and the appointment of management teams and sector experts etc. Companies are rigorously managed against clear operational and financial performance targets. This provides an early warning of areas of potential underperformance, allowing management to effect change as necessary. Near-term targets are set in the context of longer-term value creation.
- The final phase is realisation or exit. A key factor here is that the exit or value realisation strategy is determined at the outset. There are multiple exit strategies including sale to strategic or financial buyers and an IPO on a public market, but value will typically be realised through a competitive auction process to achieve the optimal return.

Key drivers of PE performance

The PE market is arguably less efficient than public markets. PE firms usually target gross returns in the order of 20% pa, which affects the entry price they are willing to pay, necessitates identifying an exit strategy from the outset and a focus on operational efficiency and capital structure. On exit, a PE investor can capture a control premium from a buyer with a lower cost of capital or ability to extract additional synergies.

Another driver of the performance of PE is the alignment of stakeholders. Management teams are heavily incentivised through equity ownership in the business. In addition, GPs' interests are aligned with those of the LPs, as the GP usually invests directly alongside the LPs and receives carried interest (a share of profits) on gains, which is only paid on realisation and usually features a hurdle return requirement and clawback provision.

The PE model compares favourably with public equity markets where the owners of the business, the shareholders, are usually fragmented with no individual control and limited information, while the executives who operate the business may only have a small personal financial interest, have superior information and may have differing incentives such as personal prestige. This is known as the principal-agent problem.

Active and nimble management is a further driver of performance: the GP actively focuses on creating shareholder value, takes a long-term view and can restructure operations and management away from the public eye. GPs add significant value to investee companies through oversight and board representation, strategic insight, operational improvements, access to additional resources and through M&A activity. Decision making also tends to be faster than in public markets where seeking shareholder approval can be a more protracted process. Equity returns are also driven by the use of higher levels of leverage than are typically seen in public companies.

Although leverage has been a factor in returns, the impact of strategic and operational improvements was been the largest contributor to realised gains on exit in the period 2005-13 (source: Ernst & Young 2014 *Taking Stock: How do private equity investors create value? A study of 2013 European exits*). Leverage for investors has been in the run-up to the financial crisis, where leverage was employed at the fund level as well as the portfolio level. Such leverage is thankfully rare today.

The PE model appears to have become better understood over time and its attractive risk/reward characteristics have led to it becoming a core allocation in most institutional portfolios reaching up to 25% for some of the largest investors.

Traditional access to PE

Direct PE investment (through taking an LP stake in an LP fund) makes most sense for those investors with significant absolute resources and a commitment to invest over a sustained period.

Traditional PE funds are not accessible to everyone. The typical minimum investment in a PE fund is in the range of $1-10m, clearly restricting the investor universe to sophisticated investors such as pension funds, endowments, other institutions, endowments, family offices and high net worth individuals (HNWs). However, this does not necessarily limit GPs' ability to raise funds, as the 'flight to quality' effect results in fund-raisings by PE fund houses with top-quartile performance often being heavily oversubscribed.

However, the real absolute resource commitment to the asset class for investors is **in reality much higher**, given the significant legal and diligence costs associated with investment in a traditional PE fund.

The strong long-term **average** return record exhibits significant yearly variability and is thus predicated on being able to diversify by **vintage year** as economic cycles wax and wane. An investor who began investing in the average 2009 vintage fund in the UK would have experienced a poor -2.1% pa return by 2014. If the investor had continued to invest in the 2010 and 2011 vintages, however, returns averaged 25.6% and 38.8% in those years respectively, easily making up for the poor 2009 year (source: *BVCA Private Equity and Venture Capital Performance Measurement Survey 2014*).

PE funds also offer limited liquidity. Investing in a PE fund requires a long-term commitment of typically seven to 10 years, with no redemption rights. There has been strong growth in secondary market transactions of participations in PE funds, but they represent only 3-5% of primary volume according to the BVCA. Moreover, the market is not very efficient, especially in smaller deals. There is no guarantee that markets will be favourable to an exit at any particular point in time (in the financial crisis of 2009 the secondary market was effectively closed).

On the other hand, one might argue that illiquidity imparts a benefit in itself, ie part of the outperformance available from investing in PE is the ability to capture an illiquidity premium by being able to provide long-term capital.

Access to the outperformance of PE does come at a cost: PE funds charge higher fees than other investment funds apart from hedge funds. Management fees of 1.5-2.0% are charged by the GP on committed capital rather than invested capital and a carried interest (or profit share) of typically 20% is levied on gains. However, despite the high fees, net returns have been very attractive in absolute terms and relative to equity markets as a whole as noted above.

Why *listed* private equity (LPE)?

How does LPE add value over the traditional LP/GP investment model? A LPE fund is simply a closed-ended investment company that raises money upfront and whose shares are listed and traded on an exchange. The company then invests like a normal LP with a professional GP managing the fund investments.

LPE funds operate in both direct investment and fund-of-funds strategies. Direct investors (including single manager funds) include Altamir SCA, Deutsche Beteiligungs, GIMV, HgCapital and

Oakley Capital. Major LPE fund-of-funds include Aberdeen Private Equity, F&C Private Equity, HarbourVest Global Private Equity, Standard Life European Private Equity and SVG Capital.

Most LPE funds own the investment assets only, but some are hybrid asset managers, where the listed entity also owns the management company. These companies tend to trade at higher valuations as the market usually attributes value to the management company in addition to the investment portfolio. LPE funds with this structure include 3i, Deutsche Beteiligungs and GIMV and all three companies are trading at significant premiums to NAV.

Addressing accessibility, liquidity & funding risk for investors

The listed structure addresses the two main drawbacks of direct LP investment: accessibility and liquidity.

LPE funds are easily accessible and open up the PE asset class to the whole universe of public market investors. The minimum investment becomes the price of one share, allowing smaller investors to take advantage of the diverse opportunities available across vintages, strategies, geographies and sectors. An investment in a listed company is simple: the investment outlay is fixed, there is no need to worry about complex legal and tax arrangements or maintaining a cash reserve to meet future funding commitments.

A listed PE investment offers daily liquidity. The shares of an LPE fund are traded on an exchange giving the investment a clear valuation. Investors can manage their cash flows easily and avoid the funding risk associated with a traditional LP structure as the cash commitments are managed at the fund level by the GP. There is still an **indirect** funding risk pertaining to LPE fund investors as funds perceived as being overextended (ie having too many future commitments relative to a realistic realisation profile and cash reserve) can suffer a relative valuation discount.

Some LPE choose to pay dividends, often out of realisations, which is more akin to the way a traditional LP makes distributions. Some LPE funds pay **regular** dividends (for instance based on a percentage of NAV), which may appeal to multi-asset investors, although it is unclear whether this strategy will attract traditional public market income investors who are concerned with dividend sustainability. This is because such distributions might still be viewed as being dependent on the environment for realisations rather than coverage by regular income.

Other advantages of LPE

Investors in LPE funds have less granular disclosure around the underlying investments than traditional LPs. LPE fund investors can, however, still access additional third-party information and research to help them compare and choose different funds and strategies and to monitor their investments. Such research would include broker research, commissioned research (such as Edison's), as well as the information available on platforms like LPEQ, BVCA, Preqin, Bloomberg and Thomson Reuters. Monitoring the performance of the investment's total return is also a simple matter of observing the share price total return.

LPE funds tend not to have explicit NAV discount management policies, but some have demonstrated a commitment to shareholder value through opportunistic buy-backs during periods of elevated discounts. This occurred in the financial crisis and recently Standard Life European Private Equity has been buying back shares in the market, for instance.

Finally, LPE funds benefit from an independent board whose duty it is to represent the interest of shareholders.

Challenges for investors

The main trade-offs to achieving accessibility and liquidity by investing through an LPE fund are a lower level of portfolio disclosure and more perceived volatility in the valuation of the investment.

The LP model is more desirable from a disclosure perspective. While LPs in a traditional PE fund usually receive regular and very detailed reports on the performance of the underlying portfolio companies, investors in LPE funds receive much less detailed information, often in a more aggregated form. This is because of confidentiality obligations and the understandable desire not to put market-sensitive information into the public domain. For direct investment strategies, disclosure may include any combination of revenues, profits and EBITDA at the fund level or for a selection of portfolio companies. That said, portfolio company disclosure has improved significantly as LPE funds recognise the importance of greater transparency. For fund-of-funds strategies, the investor is effectively buying the manager's access to and ability to interpret the wealth of information given at the LP level.

Valuation methodologies used for portfolio company valuation generally conform to the IPEV (International Private Equity and Venture Capital) valuation guidelines, but as with any valuation estimate there is an element of judgement. It is difficult to make informed valuation comparisons across LPE funds due in large part to the heterogeneity of the investments themselves and differing levels of disclosure. However, it is generally fair to say that valuations tend to err on the conservative side. Buyout funds typically value holdings using trailing earnings multiples and managers apply varying liquidity discounts. The frequency of reporting of LPE funds is also much lower than for investment companies in general and compared to the availability of data in LP structures. LPE NAVs are usually published at best quarterly and with a lag of one to three months. Some LPE fund-of-funds publish monthly estimated NAVs, which take into account cash flows, major currency movements and realisations rather than a full portfolio valuation. Disclosure around fees and expenses also varies between LPE funds, making it difficult for investors to compare them on a like-for-like basis.

In a LPE fund-of-funds, the information issue is less relevant as the investor is looking for a more diversified exposure and is in effect outsourcing the choice of fund to the fund manager. This fund manager then has access to the detailed information as an LP in each underlying fund and can use his expertise in allocating capital commensurately. Valuation is also less of an issue in fund-of-funds, where the increased diversification should be expected to mitigate portfolio risk. Fee disclosure requirements may become more important in the future for listed fund-of-funds as there may be multiple levels of charging at both the listed and underlying fund level.

Investors in LPE funds have to contend with greater **perceived** volatility of the value of their investment. The shares of a LPE fund will trade in accordance with supply, demand and liquidity and so might trade at a discount to NAV and be more volatile than the underlying investment. So, for instance, when PE returns are high and market valuation and momentum is strong, LPE funds may trade at a premium to NAV. On the other hand, when risk aversion is high listed companies can trade at significant discounts to NAV. Shares with poor liquidity will tend to trade at a structurally larger discount. However, a wide discount might attract 'value'-oriented investors seeking an attractive timing opportunity thus helping to close the discount.

Note that we describe this relative volatility as **perceived** and not necessarily **real**. First, the low frequency and lag in reporting of NAV tends to increase NAV discount variability as the market moves up and down. Second, PE managers tend not to adjust their multiple assumptions dramatically unless market multiples move significantly. Third, PE companies tend to be more financially leveraged than quoted market peers and more highly leveraged companies usually exhibit greater price volatility than less leveraged companies.

The performance challenge

LPE funds' performance does not appear to have matched that of the broader PE market in the last five to 10 years. This is more obvious over a 10-year period, which included the financial crisis. Using the LPX global index, 10-year compound returns have averaged about 5% pa, while five-year compound returns have averaged about 10%. These compare less favourably than the BVCA data quoted previously (albeit with slightly differing measurement periods and methodologies). However, we would point to a number of mitigating factors at work here.

The index performance was negatively affected by a few large outliers during the financial crisis. Companies such as Candover and 3i had deployed significant leverage at the listed company level which, combined with some bad investment decisions made at the top of the cycle and the use of leverage in portfolio companies, resulted in NAVs falling significantly. Similarly, some companies such as SVG suffered when their overcommitment strategies resulted in a funding shortfall when the financial crisis adversely impacted on PE realisations. Such incidents clearly negatively affected the overall return of the sector.

The costs of running a listed vehicle are higher than an LP structure and so overall fee levels may also be higher, especially in fund-of-funds. This difference is partly mitigated by the significant monitoring, legal and due diligence costs that must be incurred by individual LPs in the traditional fund structure.

Cash management is likely to be less efficient in LPE funds than in an LP fund (where cash is drawn from and distributed to investors so as to maximise the fund's cash efficiency) as they need to maintain some liquidity to manage overcommitment risk. This can act as a drag on returns.

Arguably, one might be willing to expect somewhat lower returns in the LPE space in exchange for much greater accessibility and liquidity.

However, performance has significantly improved over the last five years. Lessons on leverage have been learned since the crisis with leverage generally not significant at the fund level. It is also noteworthy that 3i has gone from strength to strength since its restructuring under new management. 3i's total return is nearly 30% pa over five years and the shares now trade at a **premium** to NAV of 18%. Similarly, SVG has also recovered strongly. Companies generating total returns in excess of 12% pa in the last five years include Northern Investors Co, Electra Private Equity, Pantheon International, F&C Private Equity, SVG Capital, Princess Private Equity, Standard Life European Private Equity, HarbourVest Global Private Equity and ICG Enterprise.

Untapped growth potential?

Given the intuitive appeal of LPE, there appears to be significantly untapped potential to continue to grow the sector. The average mainstream listed investment company has around 25% (and growing) of its share register represented by platforms (such as Hargreaves Lansdown and Alliance Trust Savings) and a similar amount held with private client brokers. A perusal of share registers of LPE funds across strategies shows such investors to be very much in the minority, despite the theoretical ease of accessibility by wealth managers and sophisticated individual investors under the LPE fund structure. This suggests an information gap exists over the returns and perceived 'riskiness' of PE investing and that there is an opportunity for LPE funds to engage with a wider investor audience to improve understanding of the sector.

The lack of traditional investment company buyer in the LPE space also appears to be reflected in valuations. NAV discounts over the longer term should reflect expected investment returns, liquidity and demand. LPE funds have recently been trading at wide discounts to NAV of >20%, even though investment performance has been good over the last five years.

There have been some interesting developments, which may begin to address the investor awareness issue and wide NAV discounts. In terms of investor appeal, we note the success of several investment companies with significant allocations to PE such as Scottish Mortgage, HBM Healthcare, International Biotechnology Trust and Woodford Patient Capital. In fact, Scottish Mortgage recently announced a significant increase from 10% to 25% in its maximum allocation to unlisted companies.

Some LPE funds also appear to be trying to increase their appeal through dividend actions. For example Aberdeen Private Equity Fund very recently announced a 40% rise in dividends plus a reduction in management fee. International Biotechnology Trust (which allocates up to 10% to PE) announced an inaugural dividend of 4% of year-end NAV.

In terms of expected future LPE returns, recent corporate actions by informed, sophisticated investors, such as the bid by HarbourVest for SVG Capital, might indicate that the market is beginning to recognise the mismatch between low LPE fund valuations and strong investment performance. Such activity could be viewed as calling a bottom in NAV discounts and might indicate an interesting long-term value opportunity in the sector now.

Conclusion

For investors, LPE is an accessible, liquid way to invest in an attractive asset class without the complexity and funding risk of direct PE investing. There are a range of funds and strategies available giving the investor choice and the opportunity to diversify.

Given the intuitive appeal of LPE, there appears to be significantly untapped potential to grow the sector. The listed private equity (LPE) sector is small compared to the overall PE industry (LPEQ estimates there are only 250 LPE funds globally). The shareholder registers of LPE funds do not on average reflect the growing dominance of private client wealth managers and sophisticated retail investors (via platforms) in the investment company sector as a whole. As a result, LPE funds have recently been trading at wide discounts to net asset value (NAV) of >20% even though investment performance has been good over the last five years.

This implies that an information gap exists which, if addressed through wider engagement with the investor community, could help move LPE more into the investment mainstream. Recent corporate actions by informed, sophisticated investors, such as the bid by HarbourVest for SVG Capital, might indicate that the market is beginning to recognise the mismatch between low LPE fund valuations and strong underlying investment performance. This suggests there might be an interesting value opportunity for investors in the sector now.

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